
The Task for Monetary Policy

Talk by the Governor, Mr I.J. Macfarlane, to CEDA Annual General Meeting Dinner, Melbourne, 28 November 1996.

Introduction

This is not the first time I have addressed CEDA, but it is the first time as Governor. In my new role, I am expected to say something of significance on monetary policy and I hope I will not let you down. On the other hand, my comments are meant to apply to the medium term, and there may be some disappointment to those who are expecting pointers on which way interest rates or the exchange rate will move over the next month.

How Have We Gone So Far?

In line with my medium-term emphasis, my starting point is to focus on the current expansion which has been going on for more

than five years, ie from the middle of 1991. Most other OECD countries have also been undergoing some sort of expansion over this five-year period, although some of them had a later start. When we compare ourselves with the OECD group during this period, we have clearly done well (Table 1). Australia has recorded a rate of inflation below the OECD average, and yet this has not been at the cost of feeble growth. Along with New Zealand, Australia has grown twice as fast as the OECD average. Of course, we could always have done better but, over this period, most OECD countries would prefer to have had our economic performance than their own.

There is some evidence that we are now getting recognised internationally for our improved economic performance, but I am not sure whether there is as much domestic recognition of this change. We often hear of popular dissatisfaction with the state of the economy, summarised by such terms as 'joyless recovery' or 'glum prosperity'. One important reason for this is a feeling that there has been too much economic change, and hence an increased feeling of insecurity. The two main factors here, of course, are globalisation and technological change.

Table 1: Major Economic Indicators
Average annual growth since June 1991

	GDP	Core CPI	Unemployment rate in latest month
United States	2.6	3.2	5.2
Japan	1.2	0.9	3.3
Germany	1.3	3.4	10.4
France	1.1	2.1	12.5
United Kingdom	2.0	3.2	7.4
Italy	1.0	4.7	12.0
Canada	2.0	1.9	9.9
Belgium	1.3	2.0	14.2
Netherlands	2.0	2.9	6.1
Sweden	0.7	2.5	8.8
Switzerland	-0.1	2.6	4.6
Spain	1.3	5.2	22.6
New Zealand	3.6	2.1	6.1
Australia	3.6	2.4	8.8
Average of above countries	1.9	2.8	7.5

The other reason for the disappointment in the recovery is to be found in the third column of Table 1, which shows the unemployment rate. It came down quite quickly for a time, from over 11 per cent, but after five years of growth, it is disappointing that it has not fallen further. It is little consolation to most people that our productivity performance in this upswing has been better than on previous occasions, and better than in other countries during this upswing.

The Challenge

What do we need to do to improve our performance? Clearly, with the unemployment rate at 8.8 per cent and the inflation rate at 2.4 per cent, we would all have to agree that it is the former which is in the greater need of improvement. While we all agree on this point, there is less agreement on what has to be done to bring about an improvement.

Unfortunately, there is no panacea – the answer will not be found in any single breakthrough of policy or institutional reform. Every policy and every practice should be reviewed to see whether it is contributing to or inhibiting the growth of employment. Are we putting unnecessary obstacles in the path of investment in new industries? Are our industrial relations practices more concerned with protecting the rights of people in jobs than creating new jobs? Are our welfare and retirement incomes policies encouraging people to seek work or to avoid it? Are the wage bargains that are being struck encouraging firms to put on more labour or to shed it? Is our education system turning out people with skills that make them employable?

Naturally, if we are to examine all these policies and practices, it is only right that we should look at monetary policy. As you know, the focus of our monetary policy is an inflation target, which is fully endorsed by the Government. This essentially says that monetary policy should be conducted so that, in the medium run, inflation will average

around 2½ per cent per annum. Some people have interpreted an inflation target to mean that monetary policy is only worried about inflation, and that it is therefore anti-growth. But this is not the case, as is demonstrated by the results of the past five years – where growth has been substantial while inflation has been low. The other way of expressing an inflation target is to say that monetary policy is set in a way which lets the economy grow as fast as possible without breaking the inflation objective, but no faster.

The design of our inflation target gives us the flexibility to put this into practice. Our target recognises that there will still be a business cycle and that, in the fastest growing phase, there will be a tendency for inflation to exceed our medium-term objective and, at some other times, to fall below it. We do not seek to keep within a narrow target band on a period-by-period basis. It also recognises that, in the event of a large shock, it is sensible to bring inflation back on track over time, rather than by some ‘cold turkey’ measures.

The settings of monetary policy in recent years have been consistent with low inflation on average and a good rate of economic growth. Even so, some might argue for an easier monetary policy – effectively saying ‘why not ease monetary policy as much as is necessary to encourage faster growth, even if it pushes up inflation?’ The problem with this approach is that it does not work. Faster growth may be achieved for a short period and there may be some short-term fall in unemployment, but in the medium term we end up with higher inflation and higher unemployment. This prescription has been tried before in country after country and it has failed. There is no long-term trade-off between inflation and unemployment. You cannot buy a better unemployment performance by accepting a worse inflation one. The unemployment rate would be no lower over the business cycle if we average 5 per cent inflation than if we average 2½ per cent inflation. Fortunately, this critical point is becoming increasingly accepted.

Averaging a low inflation rate does not inhibit growth or employment. What does the

serious damage to growth and employment is when inflation rises to unacceptable levels and the economy has to be squeezed to reduce it. All OECD countries have the experience of three recessions in the past three decades to remind them of this. It therefore follows that the most useful thing monetary policy can do in the long run for employment is to encourage sustainable low inflation expansions. I am not so optimistic to think that we can do away with the business cycle completely, but with good management, we should be able to delay and reduce the severity of any future contractionary phase by ensuring that inflation remains low.

As well as explaining our monetary policy framework, we have to ask ourselves whether policy could be conducted better within that framework. We have to make sure that we do not become too risk-averse and impose too restrictive a speed limit. This would be the case, for example, if we failed to take into account factors which were holding prices down, while at the same time opening up possibilities for faster growth. There certainly are many such factors – the reduction in tariffs, for example, and other aspects of globalisation in goods and capital markets; domestic factors which have increased the degree of competition in some industries; and technological changes which are producing bigger productivity improvements than in earlier periods. We recognise that these factors have played a role in our improved inflation performance over recent years and we have taken them into account in setting policy. They are making the job of conducting monetary policy easier, but they are not causing us to ‘over-achieve’ on inflation.

There are also a number of residual attitudes which are making it more difficult, some of which will be covered in the next section.

Adjusting to Low Inflation

The theme of my first speech as Deputy Governor in May 1992 was that low inflation

was here to stay – it was not just a temporary cyclical phenomenon. I am still preaching this sermon and, with five years of low inflation under our belt, plus a world that is in much the same position, a lot of people have come to share the view and have acted on it. This has led to some very useful outcomes.

Businesses have become more concerned with productivity, cost control and efficiency. Planning horizons and contracts have lengthened. The best example of this is the rebirth of fixed interest mortgages where the interest rate is locked in for up to five years. Wage bargains also have longer time horizons, with two and three-year contracts not uncommon.

As well as providing more certainty in enabling people to plan, there have also been cost savings. As the rest of the world has come to see Australia as a low inflation country, we are able to borrow on international capital markets more cheaply. Ten years ago, yields on Australian dollar bonds were 6 percentage points higher than yields on US dollar bonds; the gap has now narrowed to less than 1 percentage point (Graph 1). These gains have not been confined to business or government borrowers; mortgage interest rates are as low as they have been for a generation.

Our new found credibility in international capital markets has other policy implications. The popularity of Australian dollar investments (along with New Zealand dollar,

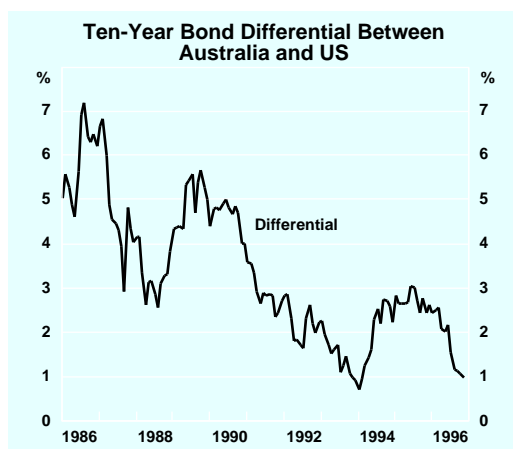
Canadian dollar and pound sterling) has lifted our exchange rate appreciably at a time of subdued commodity prices. The principal source of this inflow of funds has been the Japanese household investor who has sought alternatives to the near-zero returns on offer in Japan. While the higher currency has been helpful from an inflation perspective, it has put pressure on our export industries and those competing with imports. The pressure will be particularly felt in those industries which have let their domestic cost structure move up too fast.

There are a number of areas where the adjustment to low inflation is not proceeding as smoothly as we would like. The one I will talk about tonight is wage bargaining. I suppose this is not surprising, as over the past five years or so we have been moving from a centralised wage fixing system to an increasingly decentralised one. While this is essential to provide the flexibility for Australia to survive in an increasingly competitive world, there clearly have been some transitional difficulties. The difficulties first became apparent in the second half of 1994 when some enterprise bargains produced outcomes for wage increases which were much higher than likely inflation and overall productivity gains. There have been other instances since, and we have spent a lot of time trying to analyse what is happening.

It should also be pointed out that there appear to have been a lot of very sensible enterprise bargains and, in addition, there is a large part of the workforce that has received only small wage increases because they have not been part of the enterprise bargaining process. As a result, average wages across the whole economy have not grown at an excessive rate over the past 12 months; they have, in fact, slowed down from growth of over 5 per cent in mid 1995 to about $3\frac{3}{4}$ per cent at present. This was, of course, a very important reason why it was possible to ease monetary policy twice in the last six months.

The tensions in the wage enterprise bargaining area remain, however, and cloud the outlook for inflation, but more particularly for unemployment. This is best illustrated by

Graph 1



developments in the metals industry. Over the past two years, enterprise bargains in this sector have yielded an average increase in wages of over 5 per cent per annum. This looks high relative to a general inflation rate of 2.5 per cent, and even higher compared with the increase in prices in the metals industry, which have been only around $\frac{1}{2}$ per cent per annum. The latter figure suggests that the metals industry as a whole is very competitive and open, and metals manufacturers have virtually no pricing power. They are caught in a wage-price squeeze with potentially debilitating effects – profits in the metals industry were 30 per cent lower in the first three quarters of 1996 than a year earlier.

Note that in this sector the high wage increases have not contributed, so far at least, to increased inflation in Australia at all, as is evident by the $\frac{1}{2}$ per cent per annum increase in output prices. The effects, instead, have shown up as flat output and falling employment. In those parts of Australian industry which are open to international forces or where domestic competition is intense, excessive wage bargains are less of a worry because of their inflationary impact than because of the increased unemployment they cause.

This is not the whole of the story. In other sectors where the economy is still relatively closed, excessive wage increases will be potentially inflationary. This makes it difficult for monetary policy. We do not know the extent to which excessively high wage settlements will spread to other parts of the economy, particularly if executive pay sets a bad example, as seems to be the case at present. We also do not know the extent to which wages are pushing up unemployment or being passed into higher prices to consumers. To some extent an increase in wage dispersion might be seen as part of the normal adjustment to a less centralised labour market. But, to the extent that the leading increases serve as pace-setters for the economy as a whole, they will have an adverse impact on macroeconomic performance.

I would like to end by saying a few words about the 'Living Wage' claim currently before

the Industrial Relations Commission. The individual wage outcomes which the labour market is delivering will, in general, take account of inflation, productivity growth in the enterprise or industry in question, and the bargaining position of workers. We would not, as a result, expect to see all wages increasing at the same rate, and dispersion of wages would probably increase. This is an implication of the decision by the previous and present Governments to move to a decentralised wage fixing system after so many decades of a centralised one. We have an interest in this subject because, in the present environment, it is difficult to distinguish wage dispersion from the outlook for average wage growth. In one sense, a wider dispersion can be helpful for the smooth running of the economy in that it may well create more opportunities for people with differing skills and experience to find a job. But a significantly wider dispersion may set up tensions and pressures for 'catch up', then 'leap frogging' which can be the driving force of continuing inflation. So finding the right balance in the dispersion of wages is important.

Under present institutional arrangements, the Industrial Relations Commission has a role in deciding whether, and by how much, it should boost wages for those not covered by enterprise agreements. In doing so, it will have to balance its equity objectives against the impact of these actions on efficiency. Boosting wages at the lower end of the distribution would have two effects – it would raise the overall wage increase, and compress wage dispersion. Neither effect will be helpful for employment growth, especially for those with low skills or little work experience. Some of the least skilled will be priced out of a job, although the size of this effect is difficult to determine.

The community may well, however, wish to see some support provided for the weakest bargaining groups. While there are other policy instruments for achieving equity objectives, such alternative channels also have their efficiency costs. So intervention to nudge up minimum wages is probably a reasonable expression of community preferences. As an

example of this, the 'safety net' pursued in recent years has been compatible with low inflation. Continuation of such 'safety net' adjustments, as proposed by the Government, seems sensible to us. But if the interventions are more wide-ranging, the outcome will be slower employment growth – either because individual employers respond to the price/wage squeeze facing them, or because the Bank is forced to respond to emerging inflationary pressures by raising interest rates. Such an economy-wide macro response may seem unsatisfactory, particularly if the wages claims are seeking to re-establish longstanding wage relativities. But the alternative – to allow these incipient inflationary pressures to be transformed into higher actual inflation – is hardly beneficial to the industrially weak. It would simply erode the apparent gains made by workers at the bargaining table and in the Commission, and set the scene for further rounds of wage increases. With the painful experience of reducing inflation still fresh in our minds, we see nothing to be gained – and much to be lost – in accommodating inflationary pressures.

In time, the various players in the economy will adjust to the low inflation environment and the decentralised wage fixing system, and I feel confident that we will find, on balance, the changes are worthwhile. But new systems require new skills, and there is still a lot of

learning to be done. One requirement is that senior management will have to play a much bigger role in wage bargaining than in the past. In the new world, wages will vary from firm to firm; competitive advantage will not just be a function of which firm has the best marketing, production or finance team, but which one is best at enterprise bargaining. In the new world, wage claims will also bear a closer resemblance to what used to be termed 'capacity to pay'. Wage claims – even ambitious claims – of 7½ per cent per annum in industries with flat output and pricing prospects will not be treated seriously. Unions which pursue them will increasingly face the questioning of members who recognise that higher wages cost jobs – perhaps their own.

All this has concentrated on the linkage from wages to prices. But history tells us that this is a two-way relationship, with wages also responding to inflation, rather than causing it. I want to register with you that I understand that linkage, and understand that if workers make wage deals on the basis of low inflation, then we need to deliver that. The best contribution that monetary policy can make to safeguarding workers' real wages from erosion by inflation is to ensure that inflation stays low. You will sense, from what I have said today, that we take this commitment very seriously.